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Flaherty's Missed Opportunity

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The cheerful opening message in Finance Minister Jim Flaherty's October 30 Economic Statement was that "Canada's economic and fiscal fundamentals are rock solid." To promote capital investment, Flaherty announced a reduction in the general federal corporate income tax rate to 15 percent by 2012 from its current rate of 22.1 percent, and indicated he would seek the collaboration of the provinces and territories to reach a 25 percent combined federal-provincial-territorial statutory corporate income tax rate.

The Finance Minister's stated aim is to reduce Canada's statutory corporate income tax rate relative to other G-7 countries; yet, while lower tax rates are welcome, comprehensive tax reforms remain very much needed. The most critical of these, in business taxation, is broadening the corporate income tax base to improve tax neutrality and enable future rate reductions, particularly at the provincial level. It would be regrettable if the federal government regarded the current proposed tax relief as "mission accomplished" while leaving key reform opportunities unpursued.

In evaluating current government plans for business taxation, it is instructive to look at the effective rate on capital investment. Table 1 presents a comparison of effective tax rates across industries and provinces within Canada, while Table 2 compares Canada with other OECD member countries for manufacturing and a broad range of service sectors, excluding primary, manufacturing and financial industries. Both tables are projections for 2012, based on what we know about scheduled tax changes in Canada and elsewhere.[1] Tax jurisdictions are ranked according to their effective tax rates.

A striking point emerges from these comparisons: most service sectors in Canada will still face much higher effective tax rates than forestry and manufacturing industries (Table 1). Accordingly, the Canadian effective tax rate on the broad range of service sectors will be the sixth highest among the 30 member countries of the OECD in 2012 (Table 2). Hence, the aggregate effective tax rate for Canada, excluding the resource and financial sectors, will still be the 10th highest

1 For example, our projection for 2012 includes the previously scheduled elimination of capital tax for all non-financial corporations in Ontario. Therefore, the provincial government's recent announcement that it is accelerating such an elimination only for manufacturing and resource activities does not change the calculations shown in the two tables.

Table 1: Effective Tax Rates on Capital Investment in Canada by Industry and by Province, 2012

	Forestry	Manufac-turing	Construc-tion	Transportation and storage	Communi-cations	Public Utility	Wholesale Trade	Retail Trade	Other services	Aggregate
					percent					
Ont.	21.7	24.1	38.8	25.7	40.8	29.3	34.1	32.6	37.3	31.2
B.C.	21.2	23.4	36.1	22.8	38.1	27.6	31.8	30.2	33.0	28.6
P.E.I.	-107.6	-33.2	36.5	28.4	46.8	15.8	39.3	36.7	48.9	25.8
Sask.	14.2	15.3	32.6	20.8	33.9	25.5	30.5	28.6	33.6	23.7
Man.	-21.9	-16.1	36.2	23.2	36.5	27.8	32.6	30.5	34.4	20.2
Que.	17.9	18.9	24.9	12.8	19.0	19.6	23.3	22.5	21.9	19.5
Alta.	16.1	17.4	20.1	16.1	17.3	18.0	20.9	20.8	19.8	18.2
NS	-28.6	-17.0	13.5	19.9	22.2	-0.4	26.3	26.1	24.2	7.4
NL	-51.2	-26.9	10.4	18.6	19.1	-5.0	23.2	23.9	22.2	5.2
NB	-33.7	-22.1	10.0	17.6	19.8	-4.3	23.5	23.4	21.6	-2.6
Canada	**15.4**	**20.0**	**33.1**	**20.0**	**33.6**	**22.1**	**30.0**	**28.8**	**30.5**	**25.2**
Canada, assuming a complete retail sales tax and GST harmonization:										
	13.0	**16.8**	**22.4**	**15.4**	**19.4**	**17.1**	**23.3**	**23.2**	**21.5**	**18.6**

Note: A negative effective tax rate implies a tax saving associated with income from a new capital investment. In reality, this tax saving helps offset the tax liability arising from the investor's overall business income from new and past capital investments.

Table 2: Statutory Corporate Income Tax (CIT) Rates and Effective Tax Rates on Capital among OECD Member Countries, 2012

		Effective Tax Rates on Capital			Ranking	
	Statutory Corporate Income Tax Rate [a]	Manufacturing	Services	Average	By effective rate	By CIT rate
			percent			
US	38.1 (38.5)	32.7	39.9	36.9	1	2
France	34.4	33.0	31.7	31.9	2	3
Korea	27.5	32.8	31.0	31.5	3	15
Japan	41.9	35.2	30.4	31.3	4	1
Germany	30.2 (37.0)	30.8	29.4	29.7	5	6
UK	28.0	22.7	27.8	26.9	6	14
Australia	30.0	27.7	26.6	26.7	7	7
New Zealand	30.0 (33.0)	27.1	25.4	25.7	8	8
Spain	30.0 (32.5)	27.2	25.2	25.5	9	9
Canada	**27.3 (34.2)**	**20.0**	**29.2**	**25.2**	**10**	**16**
Norway	28.0	25.8	23.2	23.5	11	12
Finland	26.0	22.4	22.9	22.8	12	18
Turkey	20.0	22.7	20.2	20.8	13	23
Luxembourg	29.6	24.1	20.3	20.6	14	10
Austria	25.0	21.6	19.5	19.9	15	20
Italy	31.4 (37.3)	17.6	19.0	18.7	16	5
Iceland	18.0	19.5	17.6	17.9	17	28
Sweden	28.0	19.3	17.5	17.8	18	13
Portugal	26.5	14.8	16.1	15.9	19	17
Netherlands	25.5	18.2	15.0	15.5	20	19
Switzerland	18.2 (21.3)	14.8	15.0	14.9	21	27
Poland	19.0	14.4	15.0	14.9	22	25
Greece	25.0	18.0	13.2	13.8	23	22

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		Effective Tax Rates on Capital			Ranking	
	Statutory Corporate Income Tax Rate [a]	Manufacturing	Services	Average	By effective rate	By CIT rate
Denmark	25.0	16.5	12.7	13.4	24	21
Mexico	28.0	17.1	12.1	13.1	25	11
Hungary	16.0	12.9	12.0	12.2	26	29
Slovak Republic	19.0	13.3	11.7	12.0	27	26
Ireland	12.5	12.7	11.7	12.0	28	30
Czech Rep	19.0 (24.0)	10.0	7.8	8.4	29	24
Belgium	34.0	-6.0	-4.1	-4.5	30	4
Weighted average [b]	**34.7**	**29.3**	**31.2**	**30.2**		
Simple average	**26.4**	**20.6**	**19.8**	**19.8**		

Notes: Effective tax rates on capital investments incorporate corporate income taxes, sales taxes on capital purchases and other capital-related taxes including asset and net worth taxes, stamp duties on securities, and taxes on contributions to equity.

[a] The number in brackets is the statutory CIT rate for 2007, if higher than scheduled for 2012.

[b] Weighted by GDP in constant 2000 U.S. dollars for the period 2000-2005.

within the OECD; this, despite a lower ranking of 16th based on the statutory corporate income tax (CIT) rate.

This persistent inter-industry tax distortion leaves many growing service sectors penalized by high effective tax rates, while others find relief through investment tax credits, fast write-offs and reduced CIT rates in some provinces (including Ontario) for manufacturing and processing activities. Such inter-industry tax distortion is even more evident in those provinces where the provincial retail sales tax imposes a further tax burden on capital investment.

Taking the communications industry as an example, the highest effective tax rates in Canada are in Prince Edward Island (47 percent) and Ontario (41 percent), with the next highest rates being in B.C., Manitoba and Saskatchewan. This ranking parallels that of retail sales tax rates among these provinces.[2] Also note that the retail sales tax often applies to computers and computerized communication equipment-capital goods that are essential to the communications sector. Harmonization between the retail sales taxes and goods and services tax (GST) in these provinces would reduce the nationwide effective tax rate on investment in communications from 34 percent to 19 percent (see the bottom row in Table 1).

On the other end of the spectrum, the nationwide effective tax rate is only 15 percent for forestry and 20 percent for manufacturing, compared to the 34 percent for the communications sector. These significantly lower effective tax rates are due to accelerated depreciation allowances, investment tax credits and the lower CIT rate in certain provinces, provided only for manufacturing and processing activities. In this regard, Prince Edward Island provides an extreme case: despite its CIT rate

2 The retail sales tax rates for these five provinces are: 11 percent (P.E.I.), 7 percent (Ontario, British Columbia, Manitoba) and 5 percent (Saskatchewan)

(16 percent) and retail sales tax rate (11 percent) being high compared to other provinces, its investment tax credit (in addition to the Atlantic investment tax credit) helps reduce the effective tax rate for forestry and manufacturing to the lowest in Canada.

The implication of the above findings is clear: our business tax system is far from neutral. A neutral tax system would treat taxpayers equally, independent of industry sector or activity. It is distinguished by a single statutory tax rate and a broad base that leaves few preferential tax treatments for favoured groups of taxpayers. When measured by the effective tax rate on capital investment, tax neutrality means similar effective tax rates across all industries.

As illustrated in the communications sector, the non-neutrality of our tax system can be attributed in part to provincial sales taxes. If all provincial sales taxes were fully harmonized with the GST, the aggregate effective tax rate for Canada would drop to 18.6 percent in 2012 (Table 1, bottom row). A sweeping sales tax harmonization would put Canada at the midpoint on the ranking of effective tax rates among the 30 OECD member countries.

Sales tax harmonization, however, would not completely eliminate the non-neutrality of our business tax system. Without harmonization, the gap between the highest effective tax rate (34 percent) and the lowest (15 percent) is 19 percentage points. With sales tax harmonization, this gap could be reduced to 10 percentage points. This gap could be further reduced to less than five percentage points if all tax preferences for manufacturing and processing were eliminated and provincial CIT rates were unified at 10 percent.

The tax rankings shown in Table 2 are unlikely to remain constant until 2012. Other jurisdictions will continue to change their tax systems, and the competitive goalposts will continue to move. Finally, regardless of the currently solid fiscal fundamentals, continued tax rate reduction for business sectors may be difficult without base broadening. Equally, base broadening may be politically difficult without rate reductions.

It is unfortunate that the federal government missed an opportunity, with its recent tax changes, to make some fundamental reforms; in particular, changes to what and how we tax, not just at what rate. The clearest examples are the failure to link the accelerated CIT rate reduction to CIT base broadening and to link GST relief to a sweeping sales tax harmonization. This oversight should not be repeated in future federal tax changes.

References

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